IN THE HIGH COURT OF KERALA AT ERNAKULAM

PRESENT :

THE HONOURABLE MR. JUSTICE C.N.RAMACHANDRAN NAIR
&
THE HONOURABLE MR. JUSTICE K.M.JOSEPH

FRIDAY, THE 10TH NOVEMBER 2006 / 19TH KARTHIKA 1928

ST.Rev..No. 335 of 2003

AITA.31/1999 of AGRL.I.T.ADDL.BENCH,KOZHIKODE
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PETITIONER:

BHADRA ESTATES & INDUSTRIES LTD.,
EMPIRE INFANTRY, 3RD FLOOR, NO.29,INFANTRY ROAD,
BANGALORE-560 001, REPRESENTED BY ITS DIRECTOR,
MR.ZACHARIAH KURIYAN.

BY ADV. SRI.JOSEPH MARKOSE
SRI.JOSEPH KODIANTHARA

RESPONDENT:

STATE OF KERALA,
REPRESENTED BY THE SECRETARY (TAXES), TRIVANDRUM.

BY GOVT. PLEADER (SHRI GEORGEKUTTY MATHEW)

THIS SALES TAX REVISION HAVING BEEN FINALLY HEARD ON 18.9.2006, THE COURT ON 10.11.2006 PASSED THE FOLLOWING:

C. N. RAMACHANDRAN NAIR &
K. M. JOSEPH, JJ.

S.T. REV. NO. 335 OF 2003

Dated this the 10th day of November, 2006

JUDGMENT

K. M. Joseph, J.

Petitioner questions the correctness of the order of the Appellate Tribunal. Petitioner takes exception to the following findings:

(1) The disallowance of 15 per cent of the wages paid is proper.

(2) Retrenchment compensation paid to the tappers is not an allowable deduction under the AIT Act.

(3) Disallowance of 15 per cent of the Head Office expenditure apportioned to the Kerala Estate is proper.

(4) Valuation of closing stock of pepper at the average sale price realised during the year is proper.

2. Petitioner Company filed return under the Agricultural Income Tax Act. Annexure A is the order passed by the Assessing Officer. Assessing Officer proceeded to disallow certain items which are reflected in the findings as mentioned above. This has been confirmed in first appeal and also by the tribunal in further appeal.

3. We heard learned counsel for petitioner and the learned Special Government Pleader for the Revenue. Counsel for petitioner relied on the following decisions:

1) Investment Ltd. v. Commissioner of Income-Tax, Calcutta ((1970) 77 ITR 533).

2) S.S. Rajalinga Raja v. The State of Madras (AIR 1967 SC 814).

3) New Ambadi Estates Pvt. Ltd. v. State of Tamil Nadu ((1993) 200 ITR 64).

4) Cochin Malabar Estates & Industries Ltd. v. Commissioner of Agricultural Income-tax, Kerala ((1982) 135 ITR 536).

5) Chainrup Sampatram v. Commissioner of Income-Tax, West Bengal ((1953) 24 ITR 481).

6) George Oommen v. Commissioner of Agricultural Income-Tax, Kerala ((1964) 52 ITR 977).

7) M/s. Pullala & Rosary Estate v. Commr. Of Agrl. Income Tax (1993 KLJ Tax Cases221).

4. The Apex Court in Investment Ltd. v. Commissioner of Income-Tax, Calcutta ((1970) 77 ITR 533) held as follows:

> *"A taxpayer is free to employ, for the purpose of his trade, his own method of keeping accounts and for that purpose to value his stock-in-trade either at cost or at market price. A method of accounting adopted by the trader consistently and regularly cannot be discarded by the departmental authorities on the view that it should have adopted a different method of keeping account or of valuation. The method of accounting regularly employed may be discarded only if in the opinion of the taxing authorities income of the trade cannot be properly deduced therefrom. Valuation of the stock at cost is one of the recognised methods."*

In George Oommen v. Commissioner of Agricultural Income-Tax, Kerala ((1964) 52 ITR 977), the Court held as follows:

> *"Income-tax proceedings are judicial proceedings and the accounts of an assessee cannot*

> *be rejected on mere suspicion, but only on positive evidence of their unreliability. The requirement of a larger proportion of expenditure to improve an estate was not abnormal and the Commissioner's order did not disclose any material for disbelieving the assessee's accounts. On the facts the Commissioner had no jurisdiction to interfere with the order of the Agricultural Income-tax Officer."*

In New Ambadi Estates Pvt. Ltd. v. State of Tamil Nadu ((1993) 200 ITR 64), the Madras High Court took the view that disallowance of part of the expenditure on the ground that expenditure was high is unjustified. This is a case where best of judgment assessment was effected.

5. Learned counsel for petitioner would contend that a perusal of Annexure A Order would show that the order was passed under Section 39(3) notwithstanding the fact that in the body of the order, the Assessing Officer has purported to make a best of judgment assessment under Section 39(4) of the Act and issued pre-assessment notice to which the petitioner had in fact filed objection. We are not much impressed by the contention that a best of judgment assessment may not be available in the

facts of this case. The argument of the petitioner overlooks the provisions of Section 40 of the Act which permits the assessing authority, in case he finds the return to be incorrect, to make a best of judgment assessment under Section 39(4). But then, learned counsel would submit that a best of judgment assessment cannot be a capricious affair. He would point out that it is not open to the respondent to disallow expenses incurred by an assessee. He puts in focus as an example of the same, the disallowance of wages by 15 per cent on the ground of it being excessive. Learned Special Government Pleader would submit that Section 6 of the Act should provide an emphatic answer to the absence of power to reduce the deduction on the ground that it is excessive. The contention of counsel for petitioner would appear to be that the accounts audited as they are, should have called for greater circumspection from the assessing authority. While it may be open to the Officer to disallow an amount claimed to be paid on the ground that the payment was, in fact, not made, it is quite another thing and

what is more an illegality to disallow an expense merely dubbing it as excessive, it is submitted. He points out that the Officer has accepted the figures in relation to the income of the Company. He would urge that there is an increase in the income, apparently indicating that there was greater involvement of labour and it was the same which was reflected in the higher wages bill for the year in question. Likewise, he would submit that there is absolutely no warrant in departing from the ordinary rule of accountancy, namely that closing stock is to be valued at the value of the cost of the goods or produce or market price whichever is lower. He emphasised that when accounts are kept in mercantile system and if the principles are adhered to over a period of years, there is no justification on the part of the assessing officer to merely rely on the average value of sale of the produce to fix the value of the closing stock. He pointed out the difficulties which such an exercise would bring in its train in the subsequent years. Retrenchment compensation paid was not relatable to the sale of its assets, it is pointed out. It was a case

of a routine payment as retrenchment compensation as mandated by the Act and there was no basis to treat it as a capital outgo. It is likewise complained that eleven per cent of the total of head office expense was correctly accounted to the operations in the State of Kerala. The Company has plantations in the State of Karnataka as also in the State of Kerala. It is submitted that this is apparently premised in proportion to the other expenses in relation to the plantations in both the States, and there was no basis to take any exception to this reasonable method of arriving at the head office expense and apportioning the same.

6. As far as the contention of petitioner that the valuation of the closing stock as adopted by petitioner should not have been interfered with by relying on the average sale value realised during the year, we are of the view that there is merit in the said contention. It cannot be in the region of doubt that in the mercantile system of accounting, closing stock is valued either at cost value or at the market value whichever is less. The assessee has acted on the said principle. No doubt, the

reasoning of the assessing officer would appear to be that the average sale value comes to Rs.30.78 in respect of pepper during the year and therefore it is only reasonable to adopt the same for estimating income out of closing stock. No doubt, learned counsel for petitioner relied on the decision of the Apex Court in Chainrup Sampatram v. Commissioner of Income-Tax, West Bengal ((1953) 24 ITR 481), wherein the Court held as follows:

> *"While we agree with the conclusion that no part of the profits of the firm in the accounting year can be said to have accrued or arisen at Bikaner, the reasoning by which the learned Judges arrived at that conclusion seems to us, with all respect, to proceed on a misconception. It is wrong to assume that the valuation of the closing stock at market rate has, for its object, the bringing into charge any appreciation in the value of such stock. The true purpose of crediting the value of unsold stock is to balance the cost of those goods entered on the other side of the account at the time of their purchase, so*

that the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions on which there have been actual sales in the course of the year showing the profit or loss actually realised on the year's trading. As pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, 1919. "As the entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been sold, it should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods which actually have been sold at the incorrect figure.....From this rigid doctrine one exception is very generally recognised on prudential grounds and is now fully sanctioned by custom, viz., the adoption of market value at the date of making up accounts, if that value is less than cost. It is of course an anticipation of the loss that may be made on those goods in the following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the

actual sale price and the actual cost price of the goods in question" (extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to British Parliament in April, 1951). While anticipated loss is thus taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into the account, as no prudent trader would care to show increased profit before its actual realisation,. This is the theory underlying the rule that the closing stock is to be valued at cost or market price whichever is the lower, and it is now generally accepted as an established rule of commercial practice and accountancy. As profits for income-tax purposes are to be computed in conformity with the ordinary principles of commercial accounting, unless of course, such principles have been superseded or modified by legislative enactments, unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the following year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to a fall in price

below cost is allowed even if such loss has not been actually realised. As truly observed by one of the learned Judges in ***Whimster & C.*** *v.* ***Commissioners of Inland Revenue****, "Under this law (Revenue las) the profits are the profits realised in the course of the year. What seems an exception is recognised where a trader purchased and still holds goods or stocks which have fallen in value. No loss has been realised. Loss may not occur. Nevertheless, at the close of the year he is permitted to treat these goods or stocks as of their market value.....Again, it is a misconception to think that any profit "arises out of the valuation of the closing stock" and the situs of its arising or accrual is where the valuation is made. As already stated, valuation of unsold stock at the close of an accounting period is a necessary part of the process of determining the trading results of that period, and can in no sense be regarded as the "source" of such profits."*

He also relied on the decision in M/s. Pullala & Rosary Estate v. Commr. Of Agrl. Income Tax (1993 KLJ Tax Cases 221) wherein a Division Bench of this Court held as follows:

> *"The stock in trade has been transferred to the firm with a condition to retransfer the same on the termination of the lease. It was not sold by the petitioner. The same was not used or consumed by the petitioner in any business run by them. Therefore, the value of the stock in trade cannot be assessed as the agricultural income of the petitioner."*

He would contend that closing stock is valued in arriving at the net profit and it may not be correct to characterise it as an income. He pointed out the extreme exemple of a person having an opening stock and he makes purchases during the year, but transacts no business at all, leaving him with the closing stock, which would be equal to the entire opening stock to which the purchases are to be added. It is contended that it would lead to the absurd situation as the closing stock as valued will be treated as his income and he would have to pay tax thereon, when in point of fact, he had not entered into any transaction attracting

tax liability. We are of the view that the assessing officer has palpably erred in departing from the method of accounting employed in regard to the valuation of the closing stock relying on the average sale value of pepper during the year. We would, therefore, direct that the assessing authority value the closing stock as was done by the assessee in regard to pepper.

7. In regard to the question of payment of retrenchment compensation, we feel that the assessee is entitled to succeed. This is a case where retrenchment compensation was paid to some workers, even though the Company continued. Mere fact that compensation was paid to tappers is hardly sufficient to disallow the claim. This is not a case where the Company had sold any estate leading to payment of retrenchment compensation as such. Compensation was not paid owing to closure of whole or part of the business which was continuing. It is a statutory liability which the Company is liable to pay. The disallowance is found to be not justified.

8. As regards disallowance of 15 per cent of the wages

paid is concerned, the contention of learned Government Pleader that it is authorised under Section 6(d) of the Act, cannot hold good. Section 6(d), no doubt, has no application as the payment involved is wages paid to employees. The tribunal has noted that the petitioner has no case that they had employed more persons in view of increased production. It is noted that there is reduction in man power by termination of service of certain persons. The appellate authority found that in fact there was 42 per cent increase in wages. It is found that such a steep hike could not be attributed to normal increase in wage rates. The tribunal found that in the absence of any evidence to reveal that the assessee employed more workmen than the previous year or that they paid higher rate than the previous year, etc. was not valid reason to sustain 42 per cent increase and thus confirm the disallowance. It is thus on record that more workmen were not employed. In fact, number of workmen was reduced following termination of some employees. It should apparently be understood as meaning that the alleged payment of wages was

not found acceptable as genuine. The rate of increase is found at 42 per cent to be excessive. If that be so, we feel that the decision of the tribunal in this regard is beyond reproach and it is hence supported.

9. The last point falling for our decision is the reduction of the proportionate head office expenditure from 11 per cent claimed, to 5 per cent. The appellate authority has found that the reason given by the assessing authority, namely that the claim is excessive, cannot constitute a valid reason for rejecting a major portion of the claim and then proceed to allow deduction of 50 per cent of the claim of expenses under the Rubber Section, i.e. 50 per cent of Rs.2,65,973/=. The tribunal while dealing with the matter takes note of the fact that the head office at Bangalore controls the activities of the plantations in Karnataka and Kerala. The tribunal noted that Rs.2,65,973/= is 11 per cent of the total expenditure related to the rubber section. The tribunal then proceeded to note that in respect of the sister concern, 4 per cent was charged in regard to the rubber estate in

Kerala. Thereafter, the tribunal has noted that several items of expenditure under this head were not supported by any convincing piece of evidence and the appellate authority has modified the finding of the assessing authority that there was no reason for any enhancement. We note the fact that several items of expenditure under the head "Head Office Expenditure" were not found acceptable. The finding cannot, at any rate, be characterised as perverse. Hence the said finding is confirmed.

The S.T. Rev. is partly allowed as above.

C. N. RAMACHANDRAN NAIR, JUDGE

K. M. JOSEPH, JUDGE

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